Statement of
Susan Gaffney, Inspector General
Wednesday, April 1, 1998
Before the Subcommittee on Housing
and Community Opportunity
House of Representatives

Concerning Single Family Housing and the Federal Housing Administration

Chairman Lazio and Members of the Subcommittee, I appreciate the opportunity to appear before you today to discuss current issues related to HUD's single family housing program. This program is undergoing more dramatic change in its staffing and operations than any other program in the Department. In 1994, there were 2700 plus HUD staff operating single family programs nationwide; by the end of 1999, the staffing level is projected to be at 759. This downsizing of Single Family staff assumes use of rapidly changing technology, staff consolidations, and increasing reliance on the private sector to carry out many functions once performed by HUD staff.

Over recent months, OIG staff have been reviewing changes brought about by HUD's 2020 Management Reform Plan. Since Secretary Cuomo's announcement of the plan last June, major organizational changes have been taking place throughout HUD. However, changes in the single family area were in process well before the announcement of the current reform plan. In late 1993, the Office of Single Family Housing began an extensive review of its field structure and operations. The plan to consolidate functions into Homeownership Centers (HOCs) was introduced in 1994 and the first HOC in Denver began operations in August of 1994. The purpose of the consolidations was to bring HUD in line with changes taking place throughout the mortgage banking industry. HUD's 2020 Management Reform Plan was the stimulus in prioritizing and completing the organizational changes in the single family area.

Under the previous Secretary, HUD's blueprint for change called for privatizing the FHA. It was clear from the increasing insurance portfolio and the continual growth in real estate owned, that a change was needed. FHA wanted flexibility to easily adapt to market demands and better serve its customers. While Congress never approved FHA's privatization plan, HUD's current reform moves HUD from a retail to a wholesale operation, which should be less impacted by market changes. Under 2020, responsibilities for underwriting loans, servicing loans, and disposing of properties shift from HUD staff to lenders and contractors.

Under 2020, HUD defines its mission broadly as "empowering people and communities". The OIG continuously stresses the need for HUD to define and focus on its "business" mission. Several years back, FHA defined its mission in its "Business Strategy Plan". That mission was to expand and maintain affordable home ownership opportunities, on an actuarial sound basis, for those who are unserved or underserved by the private market. Based on current initiatives of this administration to expand home ownership opportunities, it appears that HUD has broadened that mission.

The OIG has repeatedly expressed our concerns over the proliferation of new HUD programs without associated staffing. In our December 1994 "Report on Opportunities for Terminating, Consolidating and Restructuring HUD Programs", we noted FHA administered about 50 programs and activities. The sheer volume of the policies, procedures, and directives needed to operate these programs impacts on HUD's ability to meet its mission.

We commend the Congress for its action three years ago in eliminating the Single Family Assignment Program. This program was shown to be staff intensive and costly to the insurance fund. There are other single family programs that are risky and/or provide limited benefit as compared to their cost to operate. For example, we recommended the elimination of the 203(k) rehabilitation loan program for investor mortgages because of the risk of fraudulent activity. Also, we have proposed the elimination of the Title I program as HUD serves such a small part of the home improvement and manufactured housing market. Again, HUD needs to clearly define its business mission and focus attention on those activities that best meet that mission.

You've asked for our specific comments in three areas: oversight of servicers' loss mitigation activities, current activities and proposals for disposing of acquired properties, and reasons for increases in foreclosures. Before I comment on these areas, I would like to put in perspective the changes taking place in Single Family under 2020.

Background

HUD's Single Family operations consist of three major activities:

- insurance processing,
- loan servicing/ loss mitigation, and
- management of real estate owned (REO).

These activities were once performed by more than 2,000 staff in 81 field locations. HUD's reform plan consolidates operations into four HOCs (Denver, Atlanta, Philadelphia, and Santa Ana), a marketing and outreach person at each of 49 field locations and a limited Headquarters staff to provide policy and oversight. This new structure is scheduled to be fully operational by September 1999. Field offices will phase in their processing and underwriting functions to the HOCs over the next several months. The last office is scheduled to be transferred in January 1999. During this transition period, Single Family field staff will remain responsible for lender oversight, loan servicing and managing the REO.

Because organizational reforms are taking place at a rapid pace throughout HUD, many staff are moving between organizations. HOCs have not been fully staffed and the Department is still determining how to fill remaining vacancies. As single family cuts are the deepest, the largest number of transitional employees are single family staff. Workloads are being transferred among offices because of various staff imbalances occurring because of the reforms.

Loan Servicing/Loss Mitigation

Loss mitigation procedures and tools replaced the assignment program. Loss mitigation allows lenders to “work out” defaults with borrowers, and mitigate losses to the FHA insurance fund by emphasizing alternatives to foreclosure. Loss mitigation procedures and tools include loan modifications, pre-foreclosure sales, special forbearance plans, partial claims, and deed-in-lieu of foreclosure.

In conjunction with recent emphasis on using loss mitigation tools, FHA developed a scoring system to rank servicers’ success in minimizing default rates relative to other lenders. A lender’s scored performance can result in various financial incentives. Bonus points are provided if the lender’s portfolio contains above-median proportions of first-time homebuyers, minority borrowers, or borrowers in underserved areas. Ninety seven lenders received incentives in 1997 and 111 will receive incentives during 1998.

Our Audit of the FHA Financial Statements for fiscal year 1997 continues to report early warning and loss prevention for insured mortgages as a material weakness. FHA does not have adequate systems, processes, or resources to identify and effectively manage risks in its insured portfolios. While FHA has developed the tools discussed above, much remains to be done to fully implement the plans and reap their benefits. Currently, FHA cannot conduct all of the monitoring efforts planned to effectively enforce program compliance and mitigate claims and losses to FHA. Our report recommended that FHA:

1. Utilize the loss mitigation scoring model to understand and predict the full impact of the different loss mitigation tools as effective alternatives to mortgage foreclosure.

2. Use the loss mitigation scoring model to not only reward lenders with satisfactory scores, but also identify lenders with unacceptable scores.

3. Develop training and awareness programs to rectify deficient servicing practices identified and eliminate non-compliant lenders from the FHA insurance programs.

4. Monitor actual use of loss mitigation tools by lenders and evaluate whether the loss mitigation program should be modified to encourage wider use.

It will be difficult for HUD to implement these recommendations in the near term. As of February 1, 1998, all loss mitigation activities were transferred to the Oklahoma City Office. As of today, this function is partially staffed with 22 employees filling the 43 available positions. There is still uncertainty as to whether 43 staff will be sufficient to handle all servicing functions. The training and monitoring for loss mitigation that is needed cannot be done at this time because of limited travel funds and insufficient staff.

Management of REO

Another objective of the reform is to contract out the REO function. It is anticipated under HUD 2020 that HUD staff will not be needed to manage the property disposition function as structured in the past. HUD's new focus will be on contractor oversight. We continue to find that HUD does not have the capacity, procedures or systems to monitor contractor performance. Improvements will be essential for such a change to work.

A basic assumption of the plan is that the private sector can purchase HUD's pipeline of foreclosures and dispose of properties quicker and cheaper. We are concerned that if privatization plans don't work as intended, HUD's options are limited.

Historically HUD has incurred certain cost to dispose of properties, (about 17% of market value). An FHA study reported that the Industry standard for disposition costs ranges between 12 and 18 percent of market value. HUD is assuming that it can find bidders in private industry to buy its pipeline of foreclosed properties, about 50,000 annually. If these bidders have lower disposition costs, perhaps the Federal Government can share in the savings. The administrative savings to accrue under the privatization plan are purely speculative until HUD seeks bids on outsourcing the REO function. We understand this solicitation is currently under development. We hope this solicitation is successful, as there won't be HUD staff available to return to the old way of doing business.

The next phase in the REO privatization plan is the sale of the pipeline of defaulted mortgage notes starting in 2002. HUD's estimated savings would accrue from interest saved from a reduced holding time. The premise is that from default to foreclosure HUD incurs 6 months interest. These savings estimates are even more tenuous. We are not in a position to adequately comment on this proposal because many of the details are missing. For example, what will be the impact on secondary mortgage market, will HUD permit these loans be re-insured, and how will loss mitigation policies be handled.

Essential in both of these privatization plans will be the need for HUD to accurately reflect property disposition costs. Bidders will need to conduct due diligence reviews to gain as much information as possible about the pipeline. HUD's Single Family Acquired Asset Management System (SAMS) is the only System HUD has to capture these costs. Our audits have found that system contains duplicate properties and properties no longer owned. Without accurate SAMS data, it will be difficult for potential bidders to adequately assess potential costs. Also, it will be difficult for HUD to have a benchmark for estimating the savings/and or added costs of pipeline sales.

Increasing Foreclosures

It is difficult to pin-point reasons for increasing FHA defaults, especially when employment rates are at an all time high and interest rates are the lowest in years. Some factors contributing to an increase in FHA defaults include:

- Liberalization of underwriting requirements in 1995 to allow more borrowers to qualify for insurance. Some of the changes included:
    - ◊ Evaluating income stability only for 3 years instead of 5;
    - ◊ Requiring debts extending 10 or more months instead of 6 months to be included in Debt-to-Income Ratios;
    - ◊ Excluding Child Care costs as a recurring debt; and,

- ◊ Permitting greater flexibility in qualifying ratios and compensating factors.

- Increased usage of Adjustable Rate Mortgages (ARMs) allowing more borrowers to qualify:
  - ◊ FHA permitted borrowers to be qualified at the lower initial interest rate rather than potential future interest rates. Recently, FHA recognized problems with ARMs and are now requiring borrowers to qualify at an interest rate of 1 point higher than the initial ARM rate.
  - ◊ Claims rates for ARMs are 1.76 percent as opposed to 1.26 percent for fixed rate mortgages.

- The flattening of home price appreciation where homeowners without equity may not have incentives to stay.

* * * * *

In summary, the Department needs to complete many complex steps in the next several months for its HUD Reform Plan to work. We continue working with management to see that reforms are successfully implemented and that decisions to outsource activities are cost effective.